

Legislative Audit Division

State of Montana



Report to the Legislature

December 2003

Financial Audit

For the Fiscal Year Ended June 30, 2003

Teachers' Retirement System

Department of Administration

A component unit of the State of Montana

This is our annual financial audit report on the Teachers' Retirement System (system) for the fiscal year ending June 30, 2003. The objectives of our financial audit included determining if the system's financial statements presented fairly its financial position and results of operations at and for the period ending June 30, 2003, with comparative totals at and for the period ending June 30, 2002.

This report contains no recommendations.

**Direct comments/inquiries to:
Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705**

03-09

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FINANCIAL AUDITS

Financial audits are conducted by the Legislative Audit Division to determine if the financial statements included in this report are presented fairly and the agency has complied with laws and regulations having a direct and material effect on the financial statements. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office. Financial audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2003, will be issued by March 31, 2004. The Single Audit Report for the two fiscal years ended June 30, 2001, was issued on March 26, 2002. Copies of the Single Audit Report can be obtained by contacting:

Single Audit Coordinator
Office of Budget and Program Planning
State Capitol
Helena MT 59620
Phone (406) 444-3616

Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

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Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel



Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

December 2003

The Legislative Audit Committee
of the Montana State Legislature:

This is our report on the financial audit of the Teachers' Retirement System (system) for the fiscal year ended June 30, 2003. The objectives of this audit include determining if the financial statements for fiscal year 2002-03 present fairly the Teachers' Retirement System's fiduciary net assets at June 30 for each fiscal year and its changes in fiduciary net assets for the fiscal years then ended. We tested compliance with laws that have a direct and material effect on the financial statements.

This report also includes Management's Discussion and Analysis, the Schedules of Funding Progress, and Employer Contributions & Other Contributing Entities. These schedules are supplementary information required by the Governmental Accounting Standards Board. As disclosed in the Independent Auditor's Report, we did not audit the information and express no opinion on it.

We issued an unqualified opinion on the financial statements of the Teachers' Retirement System. An unqualified opinion means a reader can rely on the information presented in the financial statements. The Independent Auditor's Report begins on page A-1 of this report.

Our opinion on the system's financial statements is also contained in the Teachers' Retirement System Annual Report. Copies of the annual report for fiscal year 2002-03 can be obtained from the Teachers' Retirement System. The annual report contains additional background, statistical, and actuarial information not included in this audit report, which may be of interest to legislators or the public.

This report contains no recommendations to the system. The system has reviewed and agrees with the audit report. We thank the Executive Director and his staff for their assistance and cooperation.

Respectfully submitted,

Signature on File

Scott A. Seacat
Legislative Auditor

Appointed and Administrative Officials

Teachers' Retirement Board			Term Expires
	Tim Ryan, Chair	Great Falls	7/1/04
	James Turcotte, Vice Chair	Helena	7/1/05
	Emily Hall Bogut	Kalispell	7/1/07
	Scott Dubbs	Lewistown	7/1/08
	Barbara Foster	Townsend	7/1/06
	Mona Bilden	Miles City	7/1/06

Administrative Officials

David L. Senn, Executive Director

Tammy Rau, Assistant Executive Director

Dan Gaughan, Accountant/Fiscal Manager

For additional information concerning the Montana Teachers' Retirement System, Contact David L. Senn, Executive Director, at:

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PO Box 200139
Helena MT 59620-0139

e-mail: dsenn@state.mt.us

Members of the audit staff involved in this audit were Geri Hoffman, Cindy S. Jorgenson, Sonia Powell, Jennifer Solem, and Jim Manning.

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel



Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Statement of Fiduciary Net Assets of the Teachers' Retirement System, a component unit of the state of Montana, as of June 30, 2003, and 2002, and the related Statement of Changes in Fiduciary Net Assets for each of the fiscal years then ended. These financial statements are the responsibility of the Teachers' Retirement Board. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Teachers' Retirement System as of June 30, 2003, and 2002, and the changes in fiduciary net assets for each of the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis, the Schedule of Funding Progress, and the Schedule of Contributions from the Employer and Other Contributing Entities are not a required part of the financial statements but are supplementary information required by the Governmental Accounting Standard Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

The Teachers' Retirement System actuarial gains and losses are smoothed over five years and only one fifth of each previous year's actuarial loss has been recognized in the amortization period as of July 1, 2002. This leaves almost \$443 million in unrecognized investment losses, which must be recognized over the next three to four years. This unrecognized loss, if not offset by future gains, will cause the amortization period of the unfunded actuarial accrued liability in future valuations to fall outside the measures accepted as actuarially sound.

Respectfully submitted,

Signature on File

James Gillett, CPA
Deputy Legislative Auditor

October 17, 2003

**The Teacher's Retirement System
Management's Discussion and Analysis,
Financial Statements and Notes**

TEACHERS' RETIREMENT SYSTEM MANAGEMENT'S DISCUSSION AND ANALYSIS

This discussion and analysis of the Montana Teachers' Retirement System's report provides a narrative overview of the TRS's financial activities for the fiscal year ended June 30, 2003. Please read this in conjunction with the financial statements with accompanying footnotes and required supplementary information

Overview of the Financial Statements

This report consists of two financial statements with footnotes and two schedules of historical trend information. The Statement of Fiduciary Net Assets reflects the resources available to pay benefits to retirees and beneficiaries. The Statement of Changes in Fiduciary Net Assets presents the changes that occurred in those resources for the fiscal year ended.

The Schedule of Funding Progress presents historical trend information about the actuarially funded status for the TRS plan from a long-term, ongoing perspective and the progress made in accumulating sufficient assets to pay benefits when due. The Schedule of Contributions from the Employer and Other Contributing Entities displays historical trend data of the annual required employer contributions and the actual contributions made by employers in relation to the requirement.

Financial Highlights

- The TRS plan net assets increased by \$81.9 million representing a 4% increase for the fiscal year ended June 30, 2003.
- Total contributions to the plan also increased by 4.1% from the previous year from \$100.2 million to \$104.3 million.
- Net investment income (fair value of investments plus investment income less investment expense) showed a gain for the fiscal year after having incurred losses for the two previous years. A \$126.3 million gain was achieved versus the previous year's loss of \$159.6 million.
- Pension benefits and withdrawals paid to plan members and beneficiaries totaled \$146.7 million for the fiscal year. Benefit payments increased 7.9%, \$130 million to \$140.3 million.
- Administrative expenses totaled \$1.86 million up from \$1.61 million, an increase of 15.5%.

Financial Analysis (in millions)

	<u>FY2003</u>	<u>FY2002</u>	<u>% Inc/(Dec)</u>
Cash/Cash Equivalents	\$ 67.2	\$ 45.1	49.0
Investments (fair value)	2,098.8	2,078.8	1.0
Liabilities	70.4	111.8	(37.0)
Net Assets	2,123.6	2,041.7	4.0
Contributions	104.3	100.2	4.1
Net Investment Income/(Loss)	126.3	(159.6)	>100
Benefit Pmts & Withdrawals	146.7	136.5	7.5
Administrative Expenses	1.86	1.61	15.5

- The increase in cash/cash equivalents is due primarily to an increase in our number of shares held in the Short Term Investment Pool.
- The decrease in liabilities is due mostly to a \$30.8 million decrease in the value of Securities on Loan at June 30, 2003. Also in FY2002 an \$11.1 million equity purchase was done with a trade date of June 28, 2002 and a settlement date of July 3, 2002, which straddles our fiscal year end date of June 30, 2002.
- The increase in net investment income was due primarily to the positive appreciation in the fair value of our investments.
- The increase in benefit payments and withdrawals was due to an increase in the number of retirees and beneficiaries plus the 1.5% guaranteed annual benefit adjustment.
- The increase in administrative expenses was due primarily to an increase in personal service and contracted services costs.

Overview of the Actuarial Funding

While the financial statements show a positive net investment income return of \$126.3 million for fiscal year 2003, this return is still less than what is needed to yield the actuarial assumed rate of 8.0%. Actuarial gains or losses result when the return on the actuarial value of assets differs from the actuarial investment return assumption.

Because actuarial gains and losses are smoothed over five years, only one fifth of each previous year's actuarial loss has been recognized in the amortization period as of July 1, 2002, leaving almost \$443 million in unrecognized investment losses, which must be recognized over the next three to four years. This unrecognized loss, if not offset by future gains, will cause the amortization period of the Unfunded Actuarial Accrued Liability (UAAL) in future valuations to fall outside the measures accepted as actuarially sound. Therefore, to remain actuarially sound for future years, the System will need to incur future gains that would result from, a significant recovery in the investment market, a reduction in liabilities, an increase in contribution rates, or any combination thereof.

The next actuarial valuation is schedule to be completed as of July 1, 2004, and distributed in October 2004. Based on the results of this valuation and input from our membership, the TRS Board will recommend options to the Legislature that may be necessary to remain actuarially sound.

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF FIDUCIARY NET ASSETS
JUNE 30, 2003 AND 2002

	<u>2003</u>	<u>2002</u>
ASSETS		
Cash/Cash Equivalents-Short Term		
Investment Pool (Note A)	\$ 67,248,556	\$ 45,106,331
Receivables:		
Accounts Receivable	15,568,694	14,336,758
Interest Receivable	8,927,249	9,740,964
Due from Primary Government	84,300	1,587,305
Total Receivables	<u>\$ 24,580,243</u>	<u>\$ 25,665,027</u>
Investments, at fair value (Note A):		
Mortgages	\$ 90,823,459	\$ 145,439,305
Investment Pools	1,926,576,113	1,667,824,675
Other Investments	11,326,655	165,596,248
Securities Lending Collateral (Note A)	70,099,111	99,887,388
Total Investments	<u>\$2,098,825,338</u>	<u>\$2,078,747,616</u>
Assets Used in Plan Operations:		
Land and Buildings	\$ 193,844	\$ 193,844
Less: Accumulated Depreciation	(124,827)	(121,064)
Equipment	147,087	137,249
Less: Accumulated Depreciation	(121,066)	(112,035)
Prepaid Expense	2,992	0
Intangible Assets, net of amortization (Note D)	3,320,631	3,836,503
Total Other Assets	<u>\$ 3,418,661</u>	<u>\$ 3,934,497</u>
TOTAL ASSETS	<u>\$2,194,072,798</u>	<u>\$2,153,453,471</u>
LIABILITIES		
Accounts Payable	\$ 212,760	\$ 11,732,963
Due to Primary Government	22,562	58,173
Securities Lending Liability (Note A)	70,099,111	99,887,388
Compensated Absences (Note A)	104,105	83,811
TOTAL LIABILITIES	<u>\$ 70,438,538</u>	<u>\$ 111,762,335</u>
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS	<u>\$2,123,634,260</u>	<u>\$2,041,691,136</u>

*The accompanying Notes to the Financial Statements
are an integral part of this financial statement.*

TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS
FISCAL YEARS ENDED JUNE 30, 2003 AND 2002

	<u>2003</u>	<u>2002</u>
ADDITIONS		
Contributions:		
Employer	\$ 53,276,950	\$ 51,518,712
Plan Member	50,221,491	47,872,258
Other	<u>753,838</u>	<u>762,422</u>
Total Contributions	\$ 104,252,279	\$ 100,153,392
Misc Income	\$ 4,011	\$ 0
Workers Comp. Dividend	213	255
Taxes	236	0
Investment Income:		
Net Appreciation/(Depreciation) in Fair Value of Investments	\$ 30,665,509	\$(253,162,567)
Investment Earnings	98,020,849	96,262,329
Security Lending Income (Note A)	<u>1,268,968</u>	<u>2,796,477</u>
Investment Income/(Loss)	\$ 129,955,326	\$(154,103,761)
Less: Investment Expense	2,683,417	3,074,434
Less: Security Lending Expense (Note A)	<u>1,025,993</u>	<u>2,407,203</u>
Net Investment Income/(Loss)	<u>\$ 126,245,916</u>	<u>\$(159,585,398)</u>
Total Additions	<u>\$ 230,502,655</u>	<u>\$ (59,431,751)</u>
DEDUCTIONS		
Benefit Payments	\$ 140,229,496	\$ 130,006,163
Withdrawals	6,468,324	6,472,327
Administrative Expense (Note D)	<u>1,860,967</u>	<u>1,606,737</u>
Total Deductions	<u>\$ 148,558,787</u>	<u>\$ 138,085,227</u>
NET INCREASE (DECREASE) IN PLAN NET ASSETS	\$ 81,943,868	\$(197,516,978)
NET ASSETS HELD IN TRUST FOR PENSION BENEFITS		
BEGINNING OF YEAR	2,041,691,136	2,239,208,114
Prior Period Adjustment	<u>(744)</u>	<u>0</u>
END OF YEAR	<u>\$2,123,634,260</u>	<u>\$2,041,691,136</u>

*The accompanying Notes to the Financial Statements
are an integral part of this Financial Statement.*

**TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
NOTES TO THE FINANCIAL STATEMENTS
FISCAL YEARS ENDED JUNE 30, 2003 AND 2002**

NOTE A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The Teachers' Retirement System (TRS), a discretely presented component unit Pension Trust Fund of the State of Montana financial reporting entity, maintains its accounts on the accrual basis of accounting. Employee and employer contributions are recognized as revenues in the period in which employee services are performed and expenses are recorded when the corresponding liabilities are incurred, regardless of when payment is made.

Valuation of Investments

Investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Mortgages were decreased by unamortized mortgage discount of \$17,326 in fiscal year 2003 and \$22,808 in fiscal year 2002. No investment in any one organization represents 5% or more of the net assets available for pension benefits. Investment units are bought/sold on the first business day of each month upon the decision of the Board of Investment's (BOI) Chief Investment Officer.

The six areas of investment during June 30, 2003 and 2002 include: Montana Domestic Equity Pool (MDEP)/Montana Stock Pool (MTCP); Montana International Equity Pool (MTIP); Short-Term Investment Pool (STIP); Retirement Funds Bond Pool (RFBP); Montana Private Equity Pool (MPEP), and Other Investments.

1. The BOI established creation of the MDEP in April 2003. Effective May 1, 2003, the TRS exchanged their investment in the MTCP for units in the new MDEP. The MDEP/MTCP portfolio may include common stock, equity index, preferred stock, convertible equity securities and equity derivatives. Since January 2003, MTCP unit values are calculated weekly and at the close of the last business day of the month. The initial MDEP unit value on May 1, 2003 was \$100. On conversion date, TRS MTCP units, valued at \$302 per unit, were exchanged for an equivalent value of MDEP units, issued at \$100 per unit. Unit value at June 30, 2003 and June 30, 2002 was \$106 per unit and \$317 per unit respectively.
2. MTIP portfolio includes equity investments in five funds – BOI Internal International, Pyrford International, Schroder Investment Management NA, SG Yamaichi Asset Management Inc. and Barclays Global Investors. The five funds may invest in securities of foreign-based corporations listed on legal and recognized foreign exchanges as well as domestic exchanges. Security types may include ordinary common shares, preferred shares, convertible securities, American Depositary Receipts (ADR's), Global Depositary Receipts (GDR's) and other global securities, as appropriate. Unit values are calculated weekly based upon the fair value of equity

holdings, other assets and liabilities. Unit value at June 30, 2003 and June 30, 2002 was \$83.39 per unit and \$91.12 per unit respectively.

3. STIP as per Montana Code Annotated (MCA) section 17-6-201, 202 and 204, requires investments by state agencies of available funds. The STIP unit value is fixed at \$1 for both participant buys and sells. The STIP portfolio may include asset-backed securities, commercial paper, corporate and government securities, repurchase agreements, and variable-rate (floating-rate) instruments to provide diversification and a competitive rate of return.

According to the Governmental Accounting Standards Board (GASB) Statement No. 31, Accounting and Financial Reporting for Certain Investments and External Investment Pools, STIP is considered an external investment pool. An external investment pool is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The BOI has adopted a policy to treat STIP as a 2a7-like pool.

4. RFBP portfolio includes corporate asset-backed, other corporate, U. S. government mortgage-backed, government, Yankee securities and cash investments. Unit values are calculated weekly and at month end based on portfolio pricing. Unit value at June 30, 2003 and June 30, 2002 was \$110.84 per unit and \$103.56 per unit respectively. Realized portfolio gains/losses are distributed at least annually. The RFBP portfolio includes structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits).

As of June 30, 2003 and June 30, 2002, Enron Corp. and Burlington Industries, Inc. presented legal and higher credit risks to the RFBP.

The RFBP holds a \$7 million par 6.40% Enron bond maturing July 15, 2006 and a \$7 million par 6.95% Enron bond maturing July 15, 2028. The combined book value of these securities was \$13,582,030 as of November 30, 2001. On December 12, 2001, the Enron Corp. filed for Chapter 11 bankruptcy protection. Accordingly, the November 2001 book value for the two issues was reduced to \$5.6 million as of June 30, 2002. In October 2002, the book value was reduced to \$2.8 million for both issues. In July 2003, both issues were sold, on the market, for a total of \$2.36 million.

The BOI owns a Burlington Industries, Inc., \$6 million par, 7.25% bond maturing September 15, 2005. In September 2000, the company announced a reduction of stockholders equity. Due to an increasing senior bank line and declining credit trend, the bond ratings for this issue were downgraded, in May 2001, by the Moody's and Standard & Poor's rating agencies. During fiscal year 2001, the book value of Burlington Industries Inc. was reduced from the August 31, 2000 book value of \$5,609,640 to \$2,400,000. Due to the company's filing for Chapter 11 bankruptcy

protection on November 11, 2001, the book value was reduced to \$1,200,000. In October 2003, Burlington Industries, Inc. received court approval to sell its assets. This sale is expected to close in November 2003. Under the company's recovery plan, the BOI will receive cash for its unsecured claim.

As of June 30, 2002, Rite Aid and WorldCom Inc. presented a higher credit risk to the BOI.

The RFBP owned a Rite Aid \$7,000,000 par, 7.13% bond maturing January 15, 2007. In May 2000, the BOI was subordinated to a secured bank line of credit on this issue and the bond ratings were downgraded by the Moody's and Standard & Poor's bond ratings agencies. Based on this subordination and ratings downgrade, the book value was reduced to \$5,600,000 as of June 30, 2000. During fiscal year 2001, the book value was further reduced to \$5,220,172. Due to an improving credit trend, amortization was resumed in June 2001. The book value of this security at June 30, 2002 was \$5,541,139. As of June 30, 2002, Rite Aid did not represent a credit risk. In December 2002, this bond was sold, on the market, for \$5,057,500 principal plus interest of \$206,427.

The RFBP portfolio included a \$6,000,000 par, 6.95% WorldCom Inc. bond maturing August 15, 2028. The book value of this bond, originally purchased at a discount, was \$5,477,400 on June 30, 2002. On July 21, 2002, WorldCom Inc. filed for Chapter 11 bankruptcy protection. As of July 31, 2002, the reduced book value was \$2,400,000. On November 7, 2002, the Attorney General for the State of Montana filed a lawsuit against certain WorldCom executives, directors and financial institutions associated with WorldCom such as Arthur Andersen and CitiGroup. The lawsuit, filed in Lewis and Clark County, Montana, alleges that the defendants filed "false and misleading registration statements" relating to the purchase of the bonds by the Montana Board of Investments. In December 2002, this bond was sold, on the market, for \$1.5 million.

DEUTSCHE BANK SECURITIES, INC. COMPLAINT

The BOI received a summons and complaint, dated September 3, 2002, regarding the sale of a Pennzoil Quaker State, \$5 million par, 6.75% corporate bond maturing April 1, 2009. Deutsche Bank Securities claims a "breach of contract" for the March 25, 2002 sale of the bond at a price of \$94.669 plus accrued interest. Deutsche Bank Securities seeks damages of \$538,632 for the additional costs incurred to acquire the bond from third parties, plus any statutory interest, costs and expenses. On October 1, 2002, Shell Oil Company acquired Pennzoil and subsequently announced a public tender of Pennzoil Quaker State debt. The BOI tendered the Pennzoil Quaker State holdings on October 8, 2002 at a price of \$113.099. The tender was accepted with a settlement date of November 1, 2002. On November 4, 2002, the BOI received \$5,683,075 in principal and interest plus \$150,000 as a consent fee.

5. The MPEP was established by the BOI in April 2002. The BOI contracts with six private equity managers to invest in venture capital, leveraged buyout and other private equity investments. The retained private equity managers are Adams Street Partners, Kohlberg, Kravis, Roberts and Company (KKR), Welsh Carson Anderson and Stowe, Madison Dearborn Partners,

Lexington Partners and Oaktree Capital Management. According to BOI policy, the external managers may not invest more than 20% of private equity invested capital total in non-US company partnerships unless the fund is a designated non-US fund. Venture capital represents private equity investments in early stage financing of rapidly growing companies with an innovative product or service. Leveraged buy-outs permit an investment group to acquire a company by leveraging debt, as a financing technique, to establish a significant ownership position on behalf of the company's current management team.

The TRS transferred all their venture capital and leveraged buyout investments, at cost, into the MPEP at the start-up date and were issued units according to the fair value of each participant's portfolio and cash contributions. Unit value is calculated at month end. Unit value at June 30, 2003 and June 30, 2002 was \$102.28 and \$97.38 per unit respectively.

6. Other Investments are purchased in accordance with the statutorily mandated "Prudent Expert Principle" and applicable investment restrictions of the participants. The TRS portfolio includes residential mortgages, commercial loans and real estate investments. The real estate investments and mortgages are valued based on a discounted cash flow.

Real Estate - In January 1996, the BOI, on behalf of the Public Employees' and Teachers' Retirement Systems, purchased the 100 North Park Avenue Building in Helena, Montana as a real estate investment. At June 30, 2003 the building carries a cost and fair value of \$5,830,826 and \$5,573,173, respectively. At June 30, 2002 cost and fair value was \$5,701,360 and \$5,344,000, respectively.

In August 1997, the BOI authorized the construction of an office building, as a real estate investment owned equally by the Public Employees' and Teachers' Retirement funds. At June 30, 2003, the building carries a cost and fair value of \$6,987,238 and \$7,581,770, respectively. At June 30, 2002 cost and fair value was \$6,831,438 and \$7,581,000, respectively.

Securities Lending – Under the provisions of state statutes, BOI, via a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank and Trust, to lend the BOI securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, BOI receives a fee and the custodial bank must initially receive collateral equal to 102 percent of the fair value of the loaned securities and maintain collateral equal to not less than 100 percent of the fair value of the loaned security. BOI retains all rights and risks of ownership during the loan period.

During fiscal years 2003 and 2002, State Street Bank lent, on behalf of the BOI, certain securities held by State Street, as custodian, and received US dollar currency cash, US government securities, and irrevocable bank letters of credit. State Street does not have the ability to pledge or sell collateral securities unless the borrower defaults.

The BOI did not impose any restrictions during fiscal years 2003 and 2002 on the amount of the loans that State Street Bank made on its behalf. There were no failures by any borrowers to

return loaned securities or pay distributions thereon during fiscal years 2003 and 2002. Moreover, there were no losses during fiscal years 2003 and 2002 resulting from a default of the borrowers or State Street Bank.

During fiscal years 2003 and 2002, the BOI and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and the BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the BOI could not determine. On June 30, 2003 and June 30, 2002, the BOI had no credit risk exposure to borrowers.

As of June 30, 2003, the carrying and fair value of the underlying securities on loan for the All Other Funds was \$49,363,730 and \$55,128,809, respectively. The collateral provided for the securities on loan totaled \$56,643,400 in cash collateral.

As of June 30, 2002, the carrying and fair value of the underlying securities on loan for the All Other Funds was \$101,344,163 and \$106,533,000, respectively. The collateral provided for the securities on loan totaled \$109,960,231 in cash collateral.

DEUTSCHE BANK SECURITIES, INC. COMPLAINT

The BOI received a summons and complaint, dated September 3, 2002, regarding the sale of a Pennzoil Quaker State, \$2 million par, 6.75% corporate bond maturing April 1, 2009. Deutsche Bank Securities claims a "breach of contract" for the March 25, 2002 sale of the bond at a price of \$94.669 plus accrued interest. Deutsche Bank Securities seeks damages of \$215,453 for the additional costs incurred to acquire the bond from third parties, plus any statutory interest, costs and expenses. On October 1, 2002, Shell Oil Company acquired Pennzoil and subsequently announced a public tender of Pennzoil Quaker State debt. The BOI tendered the Pennzoil Quaker State holdings on October 8, 2002 at a price of \$113.099. The tender was accepted with a settlement date of November 1, 2002. On November 4, 2002, the BOI received \$2,273,230 in principal and interest plus \$60,000 as a consent fee.

Compensated Absences

Compensated absences represent 100 percent of accrued vacation and 25 percent of accrued sick leave for TRS personnel at June 30, 2003 and June 30, 2002.

NOTE B. DESCRIPTION OF PLAN

The Teachers' Retirement Board is the governing body of a mandatory multiple-employer cost-sharing defined benefit pension plan, which provides retirement services to persons in Montana employed as teachers or professional staff of any public elementary or secondary school, colleges of technology or unit of the university system. The system was established by the state of Montana in 1937 to provide, retirement, death and disability benefits and is governed by Title 19, chapter 20, of the MCA.

At June 30, 2003, the number and type of reporting entities participating in the system were as follows:

Local School Districts	374
Community Colleges	3
University System Units	2
State Agencies	<u>8</u>
Total	387

At June 30, 2003, the system membership consisted of the following:

Retirees and Beneficiaries	
Currently Receiving Benefits	9,682
Terminated Employees Entitled to But Not Yet Receiving Benefits	11,326
Current Active Members:	
Vested	11,827
Nonvested	<u>7,710</u>
Total Membership	40,545
University System Employees	
Optional Retirement Plan (ORP)	4,739

The pension plan provides retirement benefits and death and disability benefits. Employees with a minimum of 25 years of service or who have reached age 60 with 5 years of service are eligible to receive an annual retirement benefit equal to creditable service years divided by 60 times the average final compensation. Final compensation is the average of the highest three consecutive years of earned compensation. Benefits fully vest after 5 years of creditable service. Vested employees may retire at or after age 50 and receive reduced retirement benefits. Effective July 1, 1999, legislation providing a Guaranteed Annual Benefit Adjustment of 1.5% payable each January was implemented for all retirees who had been receiving benefits for at least 36 months. This legislation also provided for a one-time ad hoc \$500 minimum benefit adjustment for any retiree who retired with at least 25 or more years of creditable service and on July 1, 1999, was receiving less than \$500 per month. The employee contribution rate was also increased from 7.044% to 7.15%.

The 2001 legislature increased the \$500 minimum benefit to \$600 for members who retired with 25 or more years of creditable service with no change in contribution rates. The legislature also authorized the TRS Board to increase GABA from 1.5% to a maximum of 3.0%, providing sufficient assets are available. The GABA was not increased in FY 2003.

NOTE C. CONTRIBUTIONS

The TRS funding policy provides for monthly employee and employer contributions at rates specified by state law. Plan members are currently required to contribute 7.15% of their earned compensation and employers contribute 7.47% of earned compensation. The State General Fund contributes an additional 0.11% of earned compensation. The Montana University System currently contributes 4.04% of the total compensation of employees participating in the ORP program. An actuary determines the actuarial implications of the funding requirement in biennial actuarial valuations. The actuarial method used to determine the implications of the statutory funding level is the entry age actuarial cost method, with both normal cost and amortization of the accrued liability determined as a level percentage of payroll. The actuarial valuation prepared as of July 1, 2002, the most recent valuation date, indicates the statutory rate was sufficient to fund the normal cost and to amortize the unfunded accrued liability under the entry age actuarial cost method over 23.4 years. The unfunded actuarial accrued liability is included in the Schedule of Funding Progress.

NOTE D. ADMINISTRATIVE EXPENSES

The administrative costs of the TRS are financed through realized investment income. The expenses, less amortization of intangible assets, may not exceed 1.5% of retirement benefits paid. Administrative expenses for the fiscal years ended June 30, 2003 and 2002, are outlined below:

	<u>2003</u>	<u>2002</u>
Personal Services:		
Salaries	\$ 589,127	\$ 470,798
Other compensation	2,000	3,300
Employee benefits	151,779	126,179
Compensated Absences	<u>20,294</u>	<u>0</u>
Total Personal Services	<u>\$ 763,200</u>	<u>\$ 600,277</u>
Operating Expenses:		
Contracted services	\$ 401,576	\$ 298,056
Supplies and materials	36,052	37,198
Communications	38,334	43,207
Travel	10,624	11,067
Rent	31,928	32,490
Repair and maintenance	34,016	22,367
Other expenses	16,571	25,585
Depreciation	12,795	13,533
Interest	<u>0</u>	<u>8,858</u>
Total Operating	<u>\$ 581,896</u>	<u>\$ 492,361</u>
Amortization	<u>\$ 515,872</u>	<u>\$ 514,099</u>
Total Administrative Expense	<u>\$1,860,968</u>	<u>\$1,606,737</u>

NOTE E. SUBSEQUENT EVENT

In May of 1999, TRS contracted with Bearing Point Inc. (formerly KPMG Consulting), to customize, integrate and implement the PeopleSoft Pension Administration, Human Resource and Financials modules. On December 23, 2002, the Board indefinitely suspended the implementation date for the PeopleSoft system in anticipation of discontinuing the contract with BearingPoint. On July 22, 2003 working through a mediator an agreement was reached in which BearingPoint would pay TRS \$1.5 million and the contract would end. TRS received the \$1.5 million payment on September 12, 2003. At June 30, 2003 the unamortized software development costs were \$3.3 million.

**Teachers' Retirement System
A Component Unit of the State of Montana
Required Supplementary Information**

**Schedule of Funding Progress
(All dollar amounts in millions)**

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liabilities (AAL) ⁽¹⁾	Unfunded Actuarial Accrued Liabilities (UAAL) ⁽²⁾	Funded Ratio	Covered Payroll ⁽³⁾	UAAL as a Percentage of Covered Payroll
July 1, 1992	\$ 954.5	\$ 1,533.9	\$ 579.3	62.2%	\$ 465.1	124.6%
July 1, 1994	1,157.5	1,712.9	555.4	67.6	472.9	117.4
July 1, 1996	1,376.7	1,939.6	562.9 ⁽⁴⁾	71.0	501.5	112.2
July 1, 1998 ⁽⁵⁾	1,809.0	2,123.3	314.3	85.2	529.8	59.3
July 1, 1998 ⁽⁶⁾	1,809.0	2,342.7	533.7	77.2	529.8	100.7
July 1, 2000 ⁽⁷⁾	2,247.5	2,648.3	400.8	84.9	537.5	74.6
July 1, 2000 ⁽⁸⁾	2,247.5	2,652.0	404.5	84.7	537.5	75.3
July 1, 2002	2,484.8	2,980.1	495.3	83.4	563.2	87.9

(1) Actuarial present value of benefits less actuarial present value of future normal costs based on entry age actuarial cost method.

(2) Actuarial accrued liabilities less actuarial value of assets.

(3) Covered Payroll includes compensation paid to all active employees on which contributions are calculated.

(4) Note that although the UAAL increased from 1994 to 1996, the Covered Payroll increased more. Therefore, both the UAAL as a Percentage of Covered Payroll and the amortization period for the UAAL decreased.

(5) Results of July 1, 1998 Actuarial Valuation.

(6) July 1, 1998 results adjusted for 1.5% GABA and \$500 minimum benefit for legislation which passed in April 1999 and the new salary scale adopted in November 1998.

(7) Results of July 1, 2000 Actuarial Valuation.

(8) July 1, 2000 results adjusted for \$600 minimum benefit for legislation passed in Spring 2001.

Teachers' Retirement System
A Component Unit of the State of Montana
Required Supplementary Information

Schedule of Contributions from the Employer and Other Contributing Entities
(All dollar amounts in thousands)

Fiscal Year Ending	Covered Employee Payroll ⁽¹⁾	Actual Employer Contributions ⁽²⁾	Actual Employer Contribution % ⁽²⁾	Annual Required Contribution (ARC) % ⁽³⁾	Percentage of ARC Contributed
6/30/1995	\$ 486,809	\$ 39,073	7.47%	7.47%	100%
6/30/1996	501,516	40,627	7.47	7.47	100
6/30/1997	511,934	41,640	7.47	7.47	100
6/30/1998	529,795	44,476	7.47	7.47	100
6/30/1999	543,071	44,987	7.47	7.47	100
6/30/2000	537,507	48,376	7.58	7.58	100
6/30/2001	567,861	51,524	7.58	7.58	100
6/30/2002	563,163	51,519	7.58	7.58	100
6/30/2003	597,131	53,277	7.58	7.58	100

(1) Computed as the dollar amount of the actual employer contribution made as a percentage of payroll divided by the contribution rate expressed as a percentage of payroll.

(2) The actual and required employer contributions are expressed as a percentage of payroll. Contributions for termination pay are included in the actual employer contribution, but are not made as a set percentage of payroll. In the Fiscal Year ended June 30, 2003 there were \$4.2 million of contributions for termination pay. Contributions made as a percentage of the salaries of the members in the Optional Retirement Plan (ORP) are included. In the Fiscal Year ended June 30, 2003, \$4.5 million was contributed based on ORP member salaries. The ORP contribution rate varies from year to year.

(3) The State makes employer contributions as a percentage of actual payroll. Thus, as long as the percentage equals the percentage required by the most recent actuarial valuation, the dollar amount of the Annual Required Contributions (ARC) is equal to the actual dollar amount of the required employer contributions.

**TEACHERS' RETIREMENT SYSTEM
A COMPONENT UNIT OF THE STATE OF MONTANA
NOTES TO THE SUPPLEMENTARY SCHEDULES
FISCAL YEARS ENDED JUNE 30, 2003 AND 2002**

Actuarial Cost Method

The actuarial valuation was prepared using the entry age actuarial cost method. Under this method, the actuarial present value of the projected benefits of each individual included in the valuation is allocated as a level percentage of the individual's projected compensation between entry age and assumed exit. The portion of this actuarial present value allocated to a valuation year is called the normal cost. The normal cost was first calculated for each individual member. The normal cost rate was defined to equal the total of the individual normal costs, divided by the total pay rate as of July 1, 2002.

The portion of this actuarial present value not provided for at a valuation date by the sum of (a) the actuarial value of the assets and (b) the actuarial present value of future normal costs is called the unfunded actuarial liability. The unfunded actuarial liability is amortized as a level percentage of the projected salaries of present and future members of the System.

Valuation of Assets - Actuarial Basis

Adopted July 1, 2000, the actuarial asset valuation method spreads asset gains and losses over five years. The expected return is determined each year based on the beginning of year market value and actual cash flows during the year. Any difference between the expected market value return and the actual market value return is recognized evenly over a period of five years. The gains and losses are measured starting with the fiscal year ended June 30, 1997.

Investment Earnings

The annual rate of investment earnings of the assets of the System is assumed to be 8%, compounded annually.

Guaranteed Annual Benefit Adjustment Increases

On January 1 of each year, the retirement allowance payable must be increased by 1.5% if the retiree's most recent retirement effective date is at least 36 months prior to January 1 of the year in which the adjustment is to be made.

Future Salaries

The rates of annual salary increases assumed for the purpose of the valuation include a 5.0% annual rate of increase in the general wage level of the membership plus a variable merit and longevity rate from 0% to 4.51%. The merit and longevity increases for the Montana University System (MUS) members did not show a pattern of increasing or decreasing with service at the time of our most recent study. Therefore, the MUS members have a flat 1% merit and longevity assumption. The general wage increase assumption was adopted July 1, 1998 and the merit and longevity scales were adopted July 1, 2002.

MUS members are assumed to have a 0.63% higher average final compensation to account for the larger than average annual compensation increases observed in the years immediately preceding retirement.

Amortization Period

The current employer contribution rate of 7.47% and the State General Fund contribution of 0.11% of members' salaries are sufficient to meet the actuarial cost of the System accruing at the valuation date and to amortize the unfunded actuarial liability over an open period of 23.4 years as of July 1, 2002.